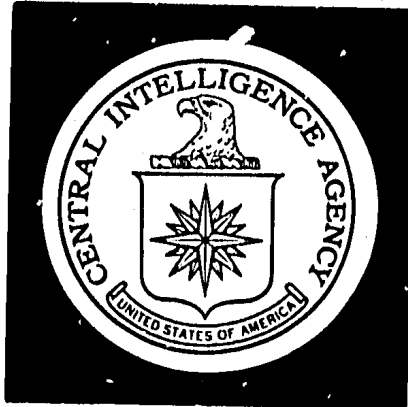


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DIRECTORATE OF
INTELLIGENCE

Intelligence Memorandum

Economic Problems Of A Buffeted Lebanon

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CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
July 1970

INTELLIGENCE MEMORANDUM

Economic Problems Of A Buffeted Lebanon

Introduction

During the past four years, Lebanon has experienced a series of shocks -- failure of its largest private bank; the Arab-Israeli war; the Israeli raid on Beirut Airport; and sporadic trouble with fedayeen, with Palestinian refugees, and with Israel. Thus the economy, which is highly dependent on internal stability and external confidence, has been buffeted repeatedly. Except for 1967, total economic activity has not declined, but the rate of expansion in some areas has slowed markedly (see Table 1). Expenditures needed to revitalize the economy have not been forthcoming from either public or private sources. The government, moreover, is faced with increasing demands on the ordinary budget -- particularly by the military and by the comparatively underprivileged Muslim majority. This memorandum traces the effects of recent Middle East disturbances on the Lebanese economy and examines Lebanon's prospects for finding funds to finance its most urgent needs.

Background

1. The Lebanese economy is based largely on the sale of services. More than one-half of gross domestic product (GDP) is derived from trade, tourism, banking, and other services. Moreover, much of the financial activity in Beirut results from the handling

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Table 1
Lebanon: Economic Indicators

	1955	1960	1965	1966	1967	1968	1969
Reserves (million US \$)	87.6	138.1	251.0	281.7	281.1	331.9	347.3
Money supply (million Lebanese pounds)	555	1,115	1,510	1,541	1,570	1,759	1,657
General price index (1950 = 100)	96	103	107	110	115	114	120
Merchandise exports (million Lebanese pounds)	108	134	264	316	367	450	N.A.
Merchandise imports (million Lebanese pounds)	708	985	1,494	1,641	1,426	1,576	N.A.
Domestic credit (million Lebanese pounds)	374	852	2,207	2,178	2,251	2,048	2,110
Construction (thousand square meters)	642.4	704.2	1,016.7	1,243.0	714.0	674.0	630.0
Tourism (percent of beds occupied)	N.A.	N.A.	60.9	58.4	40.3	46.0	40.4
Transit trade (million Lebanese pounds)	N.A.	813	997	1,050	958	1,533	N.A.
Gross domestic product (million Lebanese pounds)	1,374 a/	N.A.	3,523.4	3,866.7	3,820.1	4,240.3	N.A.

a. National income only.

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of money from individuals and corporations in other Arab countries. The unique structuring of the Lebanese economy makes it particularly susceptible to psychological factors at work both in Lebanon and abroad. Confidence in Lebanese political and economic stability encourages tourists, attracts capital, and stimulates industry; fear and uncertainty have the reverse effect. Expectations, as well as events, have a major impact on business decisions and, therefore, on prosperity. Developments that enrich the Arab world tend to enrich Lebanon; those that are costly to the Arabs are costly to the Lebanese.

2. Confidence and stability have become increasingly important to the Lebanese economy as Beirut's role in Arab economic life has grown. The 1956 Suez crisis and the Sinai war between Egypt and Israel were localized in nature and the situation was stabilized by the intervention of outside powers within a relatively brief period, and these events had little impact on the economy of Lebanon. The Lebanese civil war, which broke out in 1958 between Muslim and Christian factions, caused a sharp drop in economic activity within Lebanon but apparently was not accompanied by substantial capital flight, and the Lebanese economy recovered quickly. For a decade or more prior to 1966, Lebanese GDP grew at an average annual rate of about 5% in real terms. Meanwhile, Lebanon was becoming more dependent on foreign capital to finance trade, construction, and other investment and to support its banking institutions. Actual or threatened nationalization of private economic activities in Egypt, Syria, and Iraq in the late 1950s and early 1960s spurred the flow of foreign capital to Beirut. The fortunes of both governments and private individuals in such oil-rich countries as Saudi Arabia and Kuwait grew rapidly, and Beirut benefited. Lebanese prosperity thus became increasingly subject to the decisions of outsiders.

3. Beginning in 1966, a series of events in Lebanon and elsewhere in the Arab world have from time to time undermined confidence in its financial soundness, discouraged tourism, interfered with trade, and hampered production. Taken together, these events have slowed economic growth and have increased demands for government services while reducing the government's revenue.

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Events of 1966-70

4. When Lebanon's largest commercial bank, Intra Bank, folded in October 1966, the Lebanese banking community was thoroughly shaken and economic growth slowed (see Table 2). Investor confidence in the entire banking community declined, and depositors transferred funds from Lebanese banks to branches of foreign banks. However, the government stepped in and for the first time began to introduce effective controls over the banking sector and protection for individual depositors.

5. By the spring of 1967, confidence and economic activity had begun to revive somewhat, only to be hit with the effects of the Arab-Israeli war in June. Although Lebanon managed to avoid the war itself, its economy was measurably affected. Tourism and construction dropped sharply, precipitating a marked downturn in other economic activity. There was an absolute decline in GDP in 1967 compared with 1966. The unwillingness of local investors to place their funds in fixed assets and the unavailability of foreign capital led to a 15% decline in value added in construction. Short-term capital began to leave the country, and the banks were closed temporarily. Inflows of foreign capital were only about 10% of the 1966 level; as a result, banks were hard pressed and several folded.

6. Although the economy had again begun to pick up somewhat by the end of 1967 and continued to grow through 1968, it was jolted once more in December 1968 when the Israelis raided Beirut International Airport in retaliation for fedayeen attacks on Israeli airlines. This event depressed investment, and construction funds became very scarce. The raid was immediately followed by a rise in the price of dollars and gold on the Beirut exchange market and by tourist cancellations. However, capital outflow, as far as it can be measured, appears not to have been significant.*

* *Banking statistics prior to 1969 did not distinguish between resident and non-resident capital, and the Lebanese do not compile data on the balance-of-payments capital account.*

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Table 2
Lebanese Gross Domestic Product a/

	Million Current Lebanese Pounds					Percent		
	1964	1965	1966	1967	1968	Sectoral Share of GDP 1968	Average Annual Rate of Growth b/	
							1965-66	1967-68
Agriculture, forestry, and fishing	38.0	409.2	441.7	426.1	436.0	10.3	7.7	-0.6
Power and water	69.4	77.8	87.5	93.3	100.3	2.4	12.3	7.1
Industry and handicrafts	410.6	462.4	511.9	492.6	540.3	12.7	11.7	2.7
Construction	178.3	200.4	231.2	195.5	193.7	4.6	13.9	-8.5
Transportation and communi- cations	258.2	290.8	309.5	329.4	394.7	9.3	9.5	12.9
Dwellings	250.0	269.1	284.0	300.0	335.0	7.9	6.6	8.6
Banking and insurance	108.0	124.5	141.0	149.2	164.1	3.9	14.3	7.9
Other services (including tourism)	271.5	320.2	357.3	336.7	396.9	9.4	14.7	5.4
Trade	1,026.2	1,085.2	1,183.4	1,160.5	1,339.6	31.6	7.3	6.4
Administration	244.8	283.8	319.2	336.8	339.7	8.0	14.2	3.2
Gross domestic product	3,204.0	3,523.4	3,866.7	3,820.1	4,240.3	100.0	9.9	4.7
Net factor income from abroad	109.5	116.4	128.0	140.8	154.8	--	--	--
Gross national product	3,309.5	3,639.9	3,994.7	3,960.9	4,395.1	--	9.9	4.9

a. Because of rounding, components may not add to the totals shown.
b. The base year is the year prior to the stated period.

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7. Since the Beirut Airport raid, the government's inability to cope with either the growing number of fedayeen or the increasingly militant Israelis has contributed to economic and political instability. In 1970, Israeli retaliations in response to fedayeen incursions have forced evacuation of some 20,000 to 50,000 Lebanese from south Lebanon. These refugees have flooded north, demanding government assistance. Their supporters called a one-day strike in Beirut in May 1970, which was a complete success; all stores and businesses were closed and Beirut International Airport was temporarily shut down.

8. The Lebanese are often caught in the middle of disputes between the moderate and radical Arab states. In the most recent case, the Syrians have refused to allow the Tapline oil pipeline from Saudi Arabia to the Lebanese coast to be repaired, resulting in an estimated loss to the Lebanese government of \$10,000 to \$15,000 per day in transit revenues and other fees.

Current Problems and Immediate Prospects**The Capital Market**

9. Lebanon depends on inflows of foreign capital to balance its external payments accounts and to finance both construction and industrial investment. In the 1950s and early 1960s, Arab capital entered Lebanon in large quantities, leading to significant external influence on domestic institutions and enabling rapid economic growth. Many of the new hotels and office buildings that have sprung up in Beirut in recent years are owned by Kuwaiti and Saudi investors. Intra Bank's position was based mainly on large deposits from Kuwait, Saudi Arabia, Qatar, and the Trucial Sheikhdoms, and withdrawals by Kuwait and Saudi Arabia were instrumental in forcing it to close in 1966.

10. The flow of foreign capital into Lebanon apparently has never recovered completely since the Intra Bank crisis. Following the bank closing in 1966, there was a net outflow of about \$90 million in short-term funds from Lebanon. While the situation has since stabilized, the net inflow of short-term funds has never regained the pre-1966 level.

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In 1967 the inflow of long-term private capital dropped to \$20 million from its 1966 level of \$211 million. In 1968 this inflow amounted to only \$28 million. While no data are available for 1969, the inflow probably did not exceed the 1968 level by very much. Income from banking, which grew 15% in 1965 and 13% in 1966, increased only 6% in 1967. In 1968, when the rate of growth was higher than it had been since 1965, earnings from banking still grew only 10%.

11. Loss of confidence in Lebanese institutions, however, was only partly responsible for the reduction in the inflow of long-term private capital. The June 1967 war and its aftermath imposed major new financial burdens on those Arab countries that traditionally provided capital for the Lebanese financial community. Payments under the Khartoum agreements, donations to the fedayeen, and purchases of military equipment sopped up hundreds of millions of dollars annually, some of which Saudi Arabia, Kuwait, Libya, and others might otherwise have invested in Lebanon. Moreover, higher interest rates in more stable areas of the world attracted Arab capital.

Tourism

12. Tourism, which usually provides 12% to 13% of current foreign earnings and contributes an estimated 8% of GDP, has been hard hit by the Arab-Israeli war and the subsequent erosion of law and order. Without easy access to the Holy Land sites, Western tourists have stayed away from Lebanon in large numbers. Although this trend has been partly compensated for by increased numbers of Arab tourists, the average daily expenditure of Arab tourists is far below that of Westerners, and hotel occupancy has fallen from the 55% to 60% rate of 1964-66 to only 40% in 1969 (see Table 1). As long as the road to Jerusalem lies through Israel instead of Lebanon, earnings from tourism are not likely to increase rapidly.

Trade

13. Foreign trade is a notable exception to the otherwise dreary picture during the past several years. Overall, the foreign trade balance has improved since 1966. During the 1967 recession,

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merchandise imports for the Lebanese market fell 13%, and they have never regained their former high rates of growth. Lebanese consumers have been less inclined to buy luxury items, and importers have pared orders anticipating reduced demand at home. Concurrently, exports of Lebanese industrial products (for example, textiles, processed foods, and chemical products) have increased significantly since 1967, reflecting in part the increasing competitiveness of Lebanese industrial units. The combined result has been a reduced rate of increase in the trade gap.

14. The closure of the Suez Canal resulted in a dramatic increase in transit trade -- 60% in 1968. Lebanon is handling most of the Jordanian trade previously shipped via the port of Aqaba and has expanded its trade with Syria, Iraq, and Saudi Arabia. As a result, earnings from transit reached about \$75 million in 1967, covering about one-fourth of the trade deficit. Such earnings probably amounted to about \$105 million to \$110 million in 1968.

Demands on the Government

15. Traditionally, the role of the Lebanese government in the economy has been very limited; even such activities as education and welfare are left largely to religious communities in each locality. The national government generally has served the interests of the wealthy few -- more often than not, the Christians.

16. The Middle East conflict, however, has brought new pressures for government participation in meeting the economic needs of the people. The less affluent Muslim population, in particular, has become more vocal in demanding public development projects -- roads, dams, and irrigation facilities -- and assistance to refugees fleeing the Israeli border area. With the fedayeen already making much of their intentions to provide help for the "victims of Israeli aggression" and to arm the civilian residents of the south, the political pressure on the government to counter with official assistance programs is becoming ever greater.

17. The Lebanese army also wants more funds for equipment and for expansion. It has been shopping for equipment in several countries, including the

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United States, Belgium, France, Spain, and Sweden. The Lebanese currently are negotiating for credit to purchase 50 used tanks without reconditioning from the United States at a total cost of \$629,000 as well as machineguns. Inquiries to other countries have included requests for ammunition, tanks, armored cars, and spare parts. The army reportedly has already used up its contingency funds (spending them for fortifications, shelters, and indemnities in the south), and the funds for additional equipment purchases will have to come from the current resources of the government. Similarly, any increase in the size of the 14,000-man military establishment will impose new obligations on the budget.

18. The magnitude of the increasing financial pressures on the government is quantifiable only in the most general terms. Even before the latest round of trouble with Israel, and the concomitant increase in both civilian and military demands, the budget for 1970 envisioned military expenditures of about \$55 million -- 35% greater than in 1968 and 24% of the 1970 budget -- and an overall budget deficit of about \$30 million compared with a more normal deficit of from \$10 million to \$20 million. The government's immediate reaction to the Israeli raids was an emergency appropriation of \$10 million for refugee relief and civil defense in the south. It also revived a bill authorizing \$15 million for purchase of military equipment and began pushing a proposal for conscription and for expansion of the Lebanese army to 20,000 men that would cost some \$5 million annually over the next five years. Financing for the first of these measures apparently is not specified in the legislation while that for the second has become an issue forcing appointment of a special committee. Three months before the Presidential elections, members of the government are reluctant to place additional funds in the hands of the army, a major political force, even if they could be made available.

19. The chances of the government increasing its revenues to meet these new demands are not bright. The 1967 reduction of imports led to a corresponding fall in customs duties, which provide about 30% of government revenues (see Table 3). Actual customs duties, which were about their 1966 level, totaled 187 million Lebanese pounds (£L) in 1969. In the first four months of 1970, however, they were 5% below the 1969 level. Customs duties

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Table 3
Lebanese General Budget, by Major Category a/

	Million Lebanese Pounds				
	Actual			Budget Estimates	
	1966	1967	1968	1969	1970
Receipts					
Total	524.5	520.5	573.3	587.0	628.0
Customs duties	177.3	146.0	177.6	178.0	192.0
Excise taxes	95.0	101.0	100.6	110.5	113.6
Government properties and enterprises	14.5	15.1	17.3	16.8	19.2
Fees and dues	53.7	50.7	64.0	63.7	73.5
Direct taxes	104.3	113.8	123.1	125.5	131.5
Miscellaneous	79.7	93.9	90.7	92.5	98.2
Expenditures					
Total	547.7	591.5	603.0	660.6	728.5
Defense	105.9	121.9	127.1	160.0	171.8
Education and fine arts	82.0	90.8	95.2	112.1	123.6
Public works	133.5	128.0	128.5	94.0	123.4
Administration	18.1	29.3	30.9	27.4	31.4
Other	208.2	221.5	221.3	267.1	278.3
Deficit	-23.2	-71.0	-29.7	-73.6	-100.5

a. The value of the Lebanese pound has varied over a range of 3.13 to 3.30 Lebanese pounds to US \$1 during 1966-70, so that conversion into dollars distorts trends in budget allocations and receipts.

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obviously will not increase rapidly as long as imports are depressed; imports will not revive until consumer optimism revives. Excise taxes, which provide about one-fifth of government revenues, are similarly dependent on economic activity. The government's income from services it provides and property it owns brings in less than 15% of total revenue; increased charges, therefore, would not raise much new income. Although a 5% surtax on income was passed in 1967, revenue from income taxes dropped 1% in 1968. Attempts to pass other taxes, including a levy on gasoline, have met with considerable opposition. In an effort to appease local demands the Lebanese cabinet met in April 1970 and authorized expenditure of \$10 million to meet the needs of the south, but from all accounts these funds are not immediately available.

20. The government now is beginning to turn to sources outside of the country. Negotiations are now under way with the United States for \$7.2 million worth of Title I PL 480 wheat. The EEC has donated 15,000 tons of wheat, which is to be sold by the government to provide development funds. Lebanese leaders also have decided to seek assistance from other Arab states. Libya reportedly offered £L 50 million (£L 10 million in grants and £L 40 million in a long-term loan) to the Lebanese government in June 1970.

Conclusions

21. The Lebanese economy is unique in the Middle East in that it derives more than one-half of its GDP from service-related activities. Supplying economic services throughout the Arab world and depending on Arab money for much of new investment, the Lebanese economy is peculiarly vulnerable to events abroad. Any shift in confidence in Lebanese institutions or stability immediately has a major impact on such important sectors as tourism, banking, construction, and trade. Agriculture, which accounts for nearly half of labor force employment, is far less affected by fluctuations in investment or confidence.

22. Although the Lebanese managed to recover from past events such as the 1956 Arab-Israeli conflict and the Civil War in 1958 with minimum

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impact on the economy, the almost continuous state of crisis that has existed since late 1966 has weakened confidence, depressed the economy, and slowed economic growth.

23. As long as the Middle East conflict continues, repeated blows are a more likely prospect for the economy than a continuation of the status quo. Problems with both the fedayeen and Israel can be expected to continue as long as large concentrations of guerrillas remain on the southern border and in the refugee camps. Disputes between various Arab countries and the demands of war on other Arab states will hold down the flow of funds that would normally move to Beirut's capital market. At the same time, the government probably will have few resources at its disposal to aid the refugees, to satisfy demands of the military, and to adopt generally expensive economic programs.

24. In the present unstable political and economic situation, unpopular new taxes are not likely to be imposed. Four years of difficulties have left the Lebanese economy weakened and in a much poorer position to overcome continued disruptions than in the past.

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